EARNINGS BENCHMARKS AND TIMELINESS OF AUDIT REPORTS: CORPORATE GOVERNANCE MECHANISM AS MODERATING VARIABLE

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Abstract

This study examines the relationship the tendency of management to meet earnings targets (earnings benchmarks) and the timeliness of audit reports. The timeliness of audit reports is measured by the number of days from the date of fiscal year-end of the financial statements until the date of the audit report. While the tendency to meet the earnings target is measured using a tendency to report a slight of net income and little change in earnings compared with previous year. This study also examines the role of corporate governance mechanisms through the role of board of directors and audit committees in relation to earnings management's tendency to meet earnings targets and the timeliness of audit reports. Using 419 firm-years observation of manufacturing companies listed in Indonesia Stock Exchange (IDX) during the period of 2009-2014, as well as using multiple regression, these studies did not find evidence that earnings management using a tendency to meet earnings targets affect the timeliness of audit report. However, by using 300 firm-years observation from manufacturing industry listed on IDX for the year 2010-2014, I found weak evidence that corporate governance mechanism through the role of board of commissioners and audit committee have a moderating role that weaken the positive relationship between the tendency to meet earnings targets with the timeliness of the audit report.

Keywords*: earnings benchmarks, audit report timeliness, corporate governance, board of commissioner, audit committee*

JEL Classification: *M42*

INTRODUCTION

Past researches have documented that change in environment of financial statements and audit lead to a longer or reduced number of days in audit time (Whitworth & Lambert, 2014; Mitra et al., 2015; Pizinni et al., 2015; OJK, 2014). The number of days required to complete audited financial statements, i.e., audit delay will increase significantly with the implementation Section 404 of the SOX Act in 2002 (Pizinni et al., 2015; Ettredge et al., 2006). On the other hands, the presence of high quality internal audit section, as well as the implementation of Auditing Standard No. 5 for public listed companies introduced by the Public Company Accounting Oversight Board (PCAOB) in 2007, researchers found that the audit process become more efficient and more timely, and reduces the audit report lag (Pizinni et al., 2015; Mitra et al, 2015). Other researchers found evidence that audit quality as measured by office-specific industry expertise negatively associated with audit delay, while the higher interests on client positively associated with audit delay (Whitworth & Lambert, 2014). With the increase in audit report lag, others also found evidence the increased restatement of audited financial statements (Blankley et al., 2015).

Longer days in the timeliness of audit report is suspected to lead less relevant information to the capital market, and thus give indications of red flags and lower earnings quality (Blankley et al., 2015; 2014). This low earnings quality can be caused partly by the problem of earnings management, restatement of financial statements, and deficiency of internal control (e.g., Dechow et al., 2010; Dechow and Schrand, 2004).

Previous researchers also found that there is a tendency for managers to manage earnings to meet earnings targets (Graham et al., 2005; Brown & Caylor, 2005; Burgstahler & Dichev, 1997). Managers might engage in earnings management by focusing to achieve earnings target by avoiding to report loss or little change in income compared with the previous year (Graham et al., 2005) thus reflect bad business decisions (Burgstahler & Dichev, 1997). External auditors then need a longer time in audit process and in detecting earnings management conducted by the management that affect the timeliness of audit reports (Ettredge et al., 2006; Blankley et al., 2015; 2014). Ettredge et al., (2006) for example, found that the material weakness in internal control over financial reporting associated with longer

audit delay. Our study investigate the association between the tendency to meet earnings benchmarks as a tool of earnings management and the timeliness of audit report.

Board of commissioners and audit committee as an institution that runs the mechanisms of corporate governance have role in controlling the financial reporting process and the audit of it so as to reduce the audit delay (Nor et al., 2010; Caramanis & Lennox, 2008). Our study investigate the moderating role of board of commissioners and audit committee in the association between the tendency of management to meet earnings benchmarks and the timeliness of audit report.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The Tendency to Meet Earnings Target and Audit Report Timeliness

The achievement of earnings targets used as indicators to evaluate the performance of the entity for public listed companies, thereby reducing the cost of processing information (Graham et al., 2005). And investors prefer to invest in companies that meet or exceed the target as a reference point, so as to give a higher valuation, whichever is the company has a better performance compared to other companies (Kahnerman & Tversky, 1979).

Results of previous studies documented their increasing tendency that the management of public companies manage earnings to meet earnings targets (e.g., Graham et al., 2005; Rees, 2005). Motivation to meet earnings targets indicates that the earnings quality is low (Dechow and Schrand, 2004; Cohen & Zarowin, 2010). This indicates also that there is a problem in their internal control, i.e., for example the issues of management integrity as a part of the control environment (Arens et al., 2015).

Therefore, auditors are dealing with internal control in audit of financial statements, and auditors are likely to have longer audit time in a company problematic internal controls (e.g., Caramanis & Lennox, 2008; Brankley et al., 2014; 2015). We conclude that a tendency to meet earnings target is expected to increase audit report lag. Thus our hypothesis to be tested is formulated as follows:

H1: The tendency to meet earnings targets positively effects audit report lag.

Corporate Governance Mechanism, Earnings Benchmarks, and Audit Report Timeliness

Prior studies have documented the relationship of corporate governance with financial statement information (Bushman & Smith, 2001). Several studies have examined the association where the audit committee with the quality of financial statements (e.g., Beasley, 1996; DeFond & Jiambalvo, 1991). Other studies examined the activities and mechanisms of corporate governance with the quality of financial statements (e.g., Xie et al., 2003).

Corporate governance mechanisms have a function in the supervision of internal financial reports and can improve the quality of earnings. Studies in Indonesia, Hermawan (2011) for example, found that if the board of commissioners carry out their functions effectively, the earning response coefficients will be higher. This indicates that the earnings quality is increasingly high. Corporate governance mechanisms through the function of the board of commissioners and audit committee can help the process of monitoring the financial reporting independently, and further enhance the quality of financial reporting, and thus reduce the work of the external auditor and audit report lag.

Based on these reasons, our hypotheses to be tested in this study was formulated as follows:

H2: Corporate governance mechanism through board of commissioners and audit committee weakens (strengthen) the positive (negative) association between earnings benchmarks and audit report lag.

RESEARCH DESIGN

Sample Selection and Data Sources

Population in this study are listed companies in manufacturing industry in Indonesia Stock Exchange (BEI). We used purposive sample selection method with a criteria as follows: (i) The sample are companies listed in the Indonesia Stock Exchange with the observation period of 2009-2014; and (ii)The companies have audited financial statements with the fiscal period ended on December 31, and complete annual report.

This study uses secondary data of the financial data derived from the company's financial statements published by the Indonesia Stock Exchange (IDX), as well as on the company home page or BEI. Non-financial data source for audit committee and board of commissioners are from the annual report for the calculation of scores Board of Commissioners and the Audit Committee.

Empirical Model and Measurement of Variables

Empirical Model to test the hypothesis H1

We use two empirical model to test hypothesis H1 as follows:

$$ARL_{it} = \alpha_0 + \alpha_1 MBE_{it} + \alpha_2 BIG4_{it} + \alpha_3 OPINI_{it} + \alpha_4 ROA_{it} + \alpha_5 LEV_{it} + \alpha_6 SIZE_{it} + e_{it} \quad \text{Model 1}$$

$$ARL_{it} = \beta_0 + \beta_1 DMBE_{it} + \beta_2 BIG4_{it} + \beta_3 OPINI_{it} + \beta_4 ROA_{it} + \beta_5 LEV_{it} + \beta_6 SIZE_{it} + e_{it} \quad \text{Model 2}$$

The main variable in Model 1 is MBE (Small Earnings Level) that measures the tendency to meet earnings targets, i.e., a small earnings target. Coefficient α1 is predicted positive and significant, indicating that the tendency to meet or slightly exceed its earnings target will positively influence audit report lag (ARL). MBE is a dummy variable (1; 0), following Yulianti (2004) and Frankel et al. (2002), given 1 if net income scaled by total assets is in the interval of 0.00 and 0.02, and 0 if others. While ARl is the number of days from the date of the financial statements based on the fiscal year until the date of audit report (Blankley et al., 2015; Kneckel & Payne, 2001).

While on Model 2, the main variable is DMBE (Small Earnings Increase), which is the tendency to meet earnings targets measured by a tendency to meet or exceed little changes in earnings compared with the previous year, and predicted coefficient DMBE (β1) is positive and significant. DMBE is a dummy variable (1; 0), following Yulianti (2004) and Frankel et al. (2002), given 1, if the change in net income scaled by total assets is in the

interval of 0.00 to 0.01, and 0 if other. We use control variables in Model 1 and Model 2 i.e., BIG4, OPINION, ROA, LEV, SIZE based on the previous studies.

Empirical Model to test the hypothesis H2

We use two models to test hypothesis H2 as follows:

$$ARL_{it} = \delta_0 + \delta_1 MBE_{it} + \delta_2 DK + + \delta_3 KA + \delta_4 MBE*DK_{it} + \delta_5 MBE*KA_{it} + \delta_6 BIG4_{it} + \delta_7 OPINI_{it} + \delta_8 ROA_{it} + \delta_9 LEV_{it} + \delta_{10} SIZE_{it} + e_{it} \text{ ..... Model 3}$$

$$ARL_{it} = \lambda_0 + \lambda_1 DMBE_{it} + \lambda_2 DK + + \lambda_3 KA + \lambda_4 DMBE*DK_{it} + \lambda_5 DMBE*KA_{it} + \lambda_6 BIG4_{it} + \lambda_7 OPINI_{it} + \lambda_8 ROA_{it} + \lambda_9 LEV_{it} + \lambda_{10} SIZE_{it} + e_{it} \text{ ..... Model 4}$$

In Model 3, our main variable is MBE*DK and MBE* KA with coefficient δ4 and δ5 is predicted negative and significant. This indicates that the Board of Commissioners and the Audit Committee to perform effectively in the internal control of financial reporting, giving the effect to weaken (strengthen) the positive (negative) tendency to meet earnings targets as measured by MBE.

In Model 4, the main variable is DMBE*DK and DMBE*KA, with coefficient λ4 and λ5 is predicted negative and significant. In Model 3 and Model 4 also included some control variables, because these variables did influence variable ARL directly as with previous empirical models.

Measurement of Board of Commissioners (DK) and Audit Committee (KA)

Our measurement of the effectiveness of the Board of Commissioners (DK) and the Audit Committee (KA) follow Hermawan (2011). She used content analysis using the criteria from the Indonesian Institute for Corporate Directorship (IICD). There are three possible assessment in each question in the lists both for DK and KA: Good, Fair and Poor. The value set for Good, Fair, and Poor is 3, 2, and 1 respectively. If the total score of DK equals and more than 34, we give the value of 1, and 0 for others. And if the total score of KA equal and more than 22, we give the value of 1, and 0 for other. Please see the computation for details in Hermawan (2011).

RESULTS AND DISCUSSION

Descriptive Statistics

Descriptive statistics for Model 1 and 3 in Table 1 shows the standard deviation is relatively small, except for the variable ARL, so it can be concluded that the distribution of the variables studied are homogeneous. Mean ARL indicates that the average completion time for is 79 days. MBE, as a measure of earnings management has mean of 0.19, indicating that the proportion of listed companies to meet earnings targets (MBE) is around 19 percent. Variable DK has mean of 34.17 indicates that the number of firm-years observation has a score that indicates the board of commissioners function relatively effective, because the threshold score is 34 or higher (Hermawan, 2011). Mean of KA is 25.05, above the threshold of 22 indicates that the audit committee from the observations function effectively.

Descriptive statistics for Model 2 and Model 4 is presented in Table 2 also shows the standard deviation is relatively small for 300 firm-years of observation. Mean of ARL is 79 days, with a minimum of 33 days and a maximum amount of 177 days. The mean of DK is 34.23, and mean score of the audit committee (KA) is also above the minimum threshold of 22, i.e., 24.91.

Hypothesis Testing Results

Hypothesis Testing Results H1

Hypothesis testing results of H1 contained in Tables 3 and 4, each of which is the result of testing the hypothesis H1 using Model 1 and Model 2. Results of hypothesis testing using Model 1 in Table 3 shows that the test specifications of the model as a whole have low R-squared 3.94 percent, but significant at the 0.01 level (F-test = 5.35). MBE coefficient is not significant at 0.10 ($\alpha 1 = 1.21$, t-test = 0.52). These test results have not found evidence that the tendency to meet earnings targets by reporting a small earnings (MBE) is not associated with the length of time reporting of audits conducted by auditors.

Table 1. Descriptive Statistics of Variables - Model 1 and Model 3

Variable	Obs	Mean	Std. Dev.	Min	Max
arl	419	78.68019	17.54251	31	177
mbe	419	.1861575	.389699	0	1
dk	419	34.16706	3.677263	26	43
ka	419	25.04773	4.555623	11	32
big4	419	.3627685	.4813736	0	1
opini	419	.928401	.2581311	0	1
roa	419	.0749936	.1433222	-.7753	.8617
lev	419	.5256138	.3597631	0	1.9494
size	419	27.85609	1.740151	19.7793	35.3976

Table 2. Descriptive Statistics of Variables - Model 2 and Model 4

Variable	Obs	Mean	Std. Dev.	Min	Max
arl	300	78.55667	16.94927	33	177
dmbe	300	.1933333	.3955719	0	1
dk	300	34.23	3.580479	26	43
ka	300	24.91333	4.587225	11	32
big4	300	.36	.480802	0	1
opini	300	.93	.2555733	0	1
roa	300	.0674613	.1433573	-.7753	.6701
lev	300	.4839927	.2714795	0	1.8652
size	300	27.89382	1.821189	19.7793	35.3976

Results of hypothesis testing H1 in Model 2 using the tendency to meet earnings targets measured by reporting little changes in earnings (DMBE) can be seen in Table 4. Model 2 has R-squared 3.36 percent with F-test 3.63, significant at 0.01 level. The main variables DMBE has a coefficient β2 = 2,896, not significant at 0.10 against the ARL, consistent with the results from Model 1. In other words, we found no evidence that the tendency to report little change in net income (DMBE) have any association with the length of time the audit (ARL). In summary, the testing results of hypothesis H1 using Model 1 and 2 showed no evidence that earnings management tools using earnings benchmarks either by reporting a small profit, and little change in profit have no association with the length of audit time. Thus the hypothesis H1 is rejected.

Table 3. Testing Result of Hypothesis H1 – Model 1

```
Linear regression                               Number of obs =     419
                                                F(  6,   412) =    5.35
                                                Prob > F      =  0.0000
                                                R-squared     =  0.0394
                                                Root MSE      =  17.318
------------------------------------------------------------------------------
             |               Robust
         arl |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
         mbe |    1.209666   2.348508     0.52   0.607    -3.406887    5.826218
        big4 |   -1.304337   2.209657    -0.59   0.555    -5.647946    3.039271
       opini |   -3.044223   2.792512    -1.09   0.276    -8.533572    2.445125
         roa |   -11.66365   4.999367    -2.33   0.020     -21.4911   -1.836199
         lev |    4.654872   2.250449     2.07   0.039     .2310766    9.078667
        lnta |   -.1771328   .5704912    -0.31   0.756    -1.298569    .9443038
       _cons |    85.11669   15.77088     5.40   0.000     54.11527    116.1181
------------------------------------------------------------------------------
```

Source: Output from Stata Software

Table 4. Testing Result of Hypothesis H1 – Model 2

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Linear regression                               Number of obs =     300
                                                F(  6,   293) =    3.63
                                                Prob > F      =  0.0017
                                                R-squared     =  0.0376
                                                Root MSE      =  16.797

------------------------------------------------------------------------------
             |               Robust
         arl |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
        dmbe |    2.896245   2.913628     0.99   0.321    -2.838048    8.630538
        big4 |   -.6796036   2.778836    -0.24   0.807    -6.148612    4.789405
       opini |   -4.308813   2.572249    -1.68   0.095     -9.37124    .7536134
         roa |   -9.548456   5.639877    -1.69   0.092    -20.64826    1.551349
         lev |    4.576185   2.885615     1.59   0.114    -1.102975    10.25535
        lnta |   -.3990594   .6473169    -0.62   0.538    -1.673039    .8749207
       _cons |    91.80918    17.0491     5.38   0.000     58.25495    125.3634
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Source: Output from Stata Software

Hypothesis Testing Results H2

The test results on the hypothesis H2 are shown in Table 5 using Model 3, and Table 6 using Model 4. The test results in Model 3 shows that the model specification test results as a whole have R-squared of 4.84 percent and F-test 3.73, significant at 0.01 level. The main variables in this test, both MBE*DK and MBE*KA are not significant at the level of 0.10. This test shows no evidence that the effectiveness of the board of commissioners and audit committee effectiveness have any moderating role in their association between the tendency to meet earnings targets by reporting little profit (MBE) and the length of audit time.

Table 5. Testing Results of Hypothesis H2 – Model 3

```
Linear regression                                       Number of obs =     419
                                                        F( 10,   408) =    3.73
                                                        Prob > F      =  0.0001
                                                        R-squared     =  0.0484
                                                        Root MSE      =  17.321

------------------------------------------------------------------------------
             |               Robust
         arl |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
         mbe |    .588649   14.70446     0.04   0.968    -28.31732    29.49462
          dk |  -.3843974   .3199517    -1.20   0.230    -1.013357    .2445622
          ka |  -.0371064    .207575    -0.18   0.858    -.4451563    .3709435
      mbexdk |  -.3578355    .501399    -0.71   0.476    -1.343483    .6278124
      mbexka |   .5192951   .4479487     1.16   0.247    -.3612803    1.399871
        big4 |  -1.207109   2.385879    -0.51   0.613    -5.897259    3.483041
       opini |  -3.968105   2.768356    -1.43   0.153    -9.410127    1.473917
         roa |  -10.25272   4.845855    -2.12   0.035    -19.77868   -.7267628
         lev |   3.641524   2.437361     1.49   0.136    -1.149829    8.432876
        size |   .1188805   .5345135     0.22   0.824    -.9318636    1.169625
       _cons |   92.29898    19.5545     4.72   0.000     53.85883    130.7391
------------------------------------------------------------------------------
```

Source: Output from Stata Software

Table 6. Testing Results of Hypothesis H2 – Model 4

```
Linear regression                                       Number of obs =     300
                                                        F( 10,   289) =    4.51
                                                        Prob > F      =  0.0000
                                                        R-squared     =  0.1180
                                                        Root MSE      =  16.191

------------------------------------------------------------------------------
             |               Robust
         arl |      Coef.   Std. Err.      t    P>|t|     [95% Conf. Interval]
-------------+----------------------------------------------------------------
        dmbe |   65.09352   15.41295     4.22   0.000     34.75766    95.42939
          dk |  -.1684417   .2673467    -0.63   0.529    -.6946352    .3577517
          ka |   .2542538   .2348197     1.08   0.280    -.2079199    .7164275
     dmbexdk |  -.0226641   .0612109    -0.37   0.711    -.1431398    .0978116
     dmbexka |  -2.532932   .6066871    -4.18   0.000    -3.727018   -1.338847
        big4 |  -.3794609   2.934205    -0.13   0.897    -6.154582     5.39566
       opini |   -2.64739   2.785407    -0.95   0.343    -8.129646    2.834866
         roa |  -8.400742    5.55033    -1.51   0.131    -19.32494    2.523453
         lev |   1.708185   2.741044     0.62   0.534    -3.686755    7.103126
        size |  -.4346896   .6293146    -0.69   0.490    -1.673311    .8039315
       _cons |   79.86721   21.69293     3.68   0.000     37.17104    122.5634
------------------------------------------------------------------------------
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Source: Output from Stata Software

The test results using interaction variables DMBE*DK and DMBE*KA using Model 4 are presented in Table 6. DMBE interaction variables, DMBE*DK and DMBE*KA indicates whether the board of commissioners and audit committee have a moderating role in

the relationship between the tendency to report a little change in reporting earnings (DMBE) and the length of audit time (ARL). The test results in Table 6 shows that the model specifications have R-squared of 11.80 percent with a value of 4.51 F-test, significant at the 0.01 level. DMBE variables are positive and significant at 0.01 level, while the variable DMBE*KA negative and significant at 0.01 level. While the interaction variables DMBE*DK is not significant at 0.10. The test results on the Model 4 indicates the role of the audit committee (KA) as a moderating variable that weaken the relationship between the tendency to report little change in reported earnings (DMBE) and the timeliness of audit report (ARL).

In conclusion, from the H2 hypothesis testing using Model 3 and Model 4, we found some evidence that the mechanism of corporate governance through audit committee could weaken the positive relationship between earnings management using earnings benchmarks and the timeliness of audit report. Thus the hypothesis H2 can be accepted.

CONCLUSIONS AND RECOMMENDATIONS

This study examines the association of earnings management through earnings benchmarks, either by reporting little earnings and reporting little changes in net income to the timeliness of the audit reports. This study also examines the role of the corporate governance mechanism through the role of board of commissioners and audit committee as moderating role in the association between the tendency to meet earnings targets and the timeliness of audit report.

By using the 419 firm-years observations from listed companies in the Indonesian Stock Exchange in the year 2009-2014 and using linear multiple regression, we found no evidence that earnings management through a tendency to meet earnings target has any associations with audit report lag or the timeliness of audit report. Furthermore, this study using 300 firm-years of data observation from 2010 to 2014, found some evidence that the corporate governance mechanisms using board of commissioners and audit committee have a moderating role that weaken the positive relationship between the tendency to meet earnings targets and the length of days of audit reports.

The study found only some evidence regarding the role of audit committees in the corporate governance mechanisms. Hermawan (2011) found that when the role of board of commissioners is weak, the role of the audit committee will be much more involved. Further study must consider what kind of significant audit committee roles that give more impact in the moderating role in this association. Further study must also consider other kind of earnings management tools that board of commissioners and audit committee can minimize this tools and behavior.

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